Digital Economy Challenges: More than meets the eye

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May 16, 2019
Outline

Introduction
1. Background
2. Challenges
3. Solutions
Conclusion
Introduction
Introduction

• In the past few decades, international organizations, jurisdictions, the media and other players have been taking a closer look at international taxation.

• Question:
  • Are the changes brought about by new technology the reason we are starting to question the basic tenets of our tax system?
Introduction

• In a word: no.
• However, they have exacerbated existing problems.
• Which means we’ve got a lot to think about.
1. Background
1. Background (fundamental rules)

- There are two fundamental rules to consider:
  - Relationship
    - physical presence
    - permanent establishment
    - (articles 5 and 7 of the OECD Model Convention).
  - Attribution
    - notion of *arm’s length*
    - (article 9 of the OECD Model Convention).
1. Background (fundamental rules)

• The fundamental rules are very important:
  • Attribution is based on
    • the relationship between jurisdictions and
      • work
      • assets
      • risk
1. Background (2015)


(hereinafter the 2015 report).
1. Background (2018)

1. Background (2019)

1. Background (other references)


Jean-Pierre VIDAL, Denis LAROCQUE and Justin LEROUX, "Incidence du petit nombre de comparables sur la justice fiscale dans le domaine du prix de transfert," (2013), vol. 33, no. 2 Revue de planification fiscale et financière 243-274.
2. Challenges
2. Challenges (public opinion)

- Public opinion
- Trust in the international tax system
- Unilateral measures
2. Challenges (national interest)

- Beyond our principles, what do we have to gain?
- The figures in the table below are not a comprehensive economic study and do not lead to any conclusion. They simply show how important the issue is.

<table>
<thead>
<tr>
<th>CANADA, 2017</th>
<th>Receipts</th>
<th>Payments</th>
<th>Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer and information services</td>
<td>8,078</td>
<td>4,847</td>
<td>3,231</td>
</tr>
<tr>
<td>Audio-visual services</td>
<td>2,908</td>
<td>2,943</td>
<td>-36</td>
</tr>
</tbody>
</table>

Statistics Canada. Table 36-10-0006-01, International transactions in services, commercial services by category, annual (x $1,000,000)
2. Challenges (consensus)

- Consensus between nations
- Disagreements
  - no radical reform
  - targeted changes to existing rules
  - digital presence
2. Challenges (relationship and attribution)

- Example: Oscar
  - Oscar is a software program that uses resources in several jurisdictions to provide services in several jurisdictions. Enough people were involved in its development that it cannot be tied back to any specific individuals. Some people played a more important role than others, but it is impossible to say who or where they are from.
2. Challenges (relationship and attribution)

- Example: Oscar (continued)
  - The part of Oscar that provides a service to people is indeterminate.
  - Oscar does not require human intervention to work.
  - The marginal cost of the service rendered is almost nil.
  - The price paid for the service can be quite high.
2. Challenges (relationship and attribution)

- Example: GoldThing
  - GoldCo has a monopoly, which gives it a high residual margin on GoldThing.
    - Traditionally, the residual margin must go where the intangibles are.
    - However, this logic is flawed.
2. Challenges (relationship and attribution)

- Example: GoldThing (continued)
  - GoldThing could have been discovered by chance, without human intervention.
  - GoldCo could have carried out the project in any jurisdiction or even in the air, in space or on the ocean floor.
  - There is no concrete relationship between the intangibles and any given jurisdiction.
  - Attribution is not possible. The notion of arm’s-length dealings does not apply, since it is based on comparisons and no comparisons can be made.
2. Challenges (relationship and attribution)

- In both examples, the residual profit split method would likely be used. However, the allocative key would be arbitrary.
  - For example, sales in each jurisdiction.
  - The incorporeal property in each jurisdiction cannot be used (we’ll see why in slide 33).
2. Challenges (qualification)

- Profit
- Royalty
- Service
3. Solutions
3. Solutions

• I won’t get into all the solutions that have been put forward.
• I’ll only be discussing certain categories of solutions that apply to income tax (Part I).
• I won’t touch on any solutions concerning government revenues such as:
  • withholding taxes (Part XIII)
  • value-added taxes
  • sales taxes
3. Solutions

- Main weak points of current fundamental rules:
  - there is no concrete relationship between some types of profits and a given jurisdiction;
  - there is no solid way of attributing some types of profits to a given jurisdiction;
  - attribution is based on allocative keys that are always somewhat arbitrary.
3. Solutions

- Multinationals have two types of revenues or profits:
  - routine net margin
  - residual net margin
3. Solutions

• The problems lie with the residual net margin.
  • Monopolistic profits
  • Oligopolistic profits
  • Imperfect competition

• Unfortunately, value is not always related to the work required.
3. Solutions

- This has always been a problem.
- The difference today is that the problem is exacerbated by new technology that has further distanced value creation from the functions performed (the work done) by humans.
3. Solutions

- The solutions in OECD Actions 8 to 10 do not solve the problem.
  - They make it worse by further emphasizing the functions (or work) in value creation.
3. Solutions

• Some of the problems arising from the digital economy are a subset of larger problems resulting from the residual net margin.
3. Solutions

• The usual solution to the residual margin problem is the residual profit split method.

• However, it isn’t perfect!
3. Solutions

• Argument:
  • The *residual profit split method* is flawed because it depends on an *arbitrary allocative key*.

• Counter-argument:
  • The allocative key isn’t arbitrary; it represents the relative value of the intangibles.
3. Solutions

• Proof that the counter-argument is invalid:
  • Intangibles’ value in a jurisdiction are discounted future earnings in that jurisdiction.
  • As a result, future earnings cannot be based on intangibles’ value in a jurisdiction.
3. Solutions

• The solution is simpler than you’d think:
  • The jurisdictions simply need to agree on an allocative key that, while arbitrary, would be reasonable (sales, for example).
3. Solutions

• If jurisdictions are unable to agree on an arbitrary allocative key (such as sales), the residual profit split method cannot prevent assets, labour and risks from being relocated to a jurisdiction with lower tax rates.

• This is why the United States adopted GILTI!
3. Solutions

- Foreign income is taxed in the hands of shareholders
  - CFCs
  - Global Intangible Low-Taxed Income (GILTI)
  - USA, 2017, §951A
3. Solutions

- Since it is also somewhat arbitrary, GILTI is not an ideal solution either.
Conclusion
Conclusion

• New technology has exacerbated a set of existing international taxation problems.
• There is a simple solution, but it would require jurisdictions to use at least one arbitrary allocative key in the residual profit split method.
Thank you!